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BY THE U.S. GENERAL ACCOUNTING OFFICE

COMPLETED

Report To The Secretary Of The Treasury

ORIGINAL

Uncertainties About The Definition And Scope Of The Property Concept May Reduce Windfall Profit Tax Revenues

The Crude Oil Windfall Profit Tax Act of 1980 contains a target revenue amount--$227 billion--to be collected over approximately a 10-year period.

The basic determinant of the windfall profit tax rate is "property," a concept which the act incorporates by reference to Department of Energy regulations. The property concept is singularly important because it controls the category or tier of crude oil which, in turn, establishes the applicable windfall profit tax rate, ranging from 30 percent to 70 percent.

Notwithstanding its significance, there is considerable uncertainty over the property concept within both IRS and the oil industry. IRS has suspended certain examinations pending development of more definitive guidance. Similarly, some oil companies have raised questions about the reference year for making property determinations and about the scope of the property concept.

Uncertainty over the meaning of a cornerstone term promotes neither voluntary compliance nor effective IRS examinations. Thus, Treasury and IRS need to quickly resolve uncertainties over the property concept.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-206634

The Honorable Donald T. Regan
The Secretary of the Treasury

Dear Mr. Secretary:

For the past several months, we have been surveying Treasury Department and Internal Revenue Service (IRS) administration of the Crude Oil Windfall Profit Tax Act of 1980. The act contains a target revenue amount--$227 billion--to be collected over approximately a 10-year period.

The basic determinant of the windfall profit tax rate is "property," a concept which the act incorporates by reference to Department of Energy (DOE) regulations. Thus, property has the same meaning for windfall profit tax rate purposes as it had for DOE price control purposes. The property concept is singularly important because it controls the category or tier of crude oil which, in turn, establishes the applicable windfall profit tax rate from a range of 30 percent to 70 percent. 1/ Because properties generally are defined in DOE regulations in accordance with boundaries that existed in 1972, subsequent subdivisions of land ordinarily do not establish new properties for windfall profit tax rate purposes. If such subdivisions were permitted, taxpayers could easily change the tier classification of oil, thereby reducing the windfall profit tax rate by as much as 40 percent.

1/The Windfall Profit Tax Act defines tier 1 oil by exclusion, i.e., such oil means "any taxable crude oil other than tier 2 oil and tier 3 oil." Generally, tier 1 oil may be referred to as old oil. In tier 2, the main category is stripper oil, which is defined as crude oil from a property whose average daily production per well does not exceed 10 barrels per day. In tier 3, newly discovered oil is perhaps the most important category. This is oil from a property which had no production in one specific year, 1978.

Despite its importance, we found that considerable uncertainty surrounds the property concept within IRS. Our work in IRS' Southwest region, the lead and most active of the Service's seven regions in the windfall profit tax program, showed that property issues were treated inconsistently and inaccurately during initial IRS examinations of oil well operators. As a result, examiners were not making correct property determinations and could not accurately verify reported windfall profit tax liabilities.

We discussed our findings with representatives from IRS' Southwest regional office. To the extent possible, the region took quick corrective action at the local level, which included suspending the closure of certain cases with property issues until more definitive guidance could be developed. Recently, IRS' national office extended the case closure suspension to the Service's other regions and brought the property issue to the Treasury Department's attention. Given the program-wide significance of the property concept and its pivotal role in determining windfall profit tax rates, Treasury and IRS need to quickly develop and disseminate guidance on the basic definition of property and the appropriate examination approach. By doing so, Treasury and IRS would help assure establishment of a more effective compliance program. 1/

In carrying out our survey, we participated in IRS' windfall profit tax training program and discussed property issues with DOE personnel. We also made a series of visits in August, September, and October 1981 to five district offices in IRS' Southwest region--Albuquerque, Austin, Dallas, Denver, and Oklahoma City. During those visits, we discussed a variety of windfall profit tax compliance issues with district office managers, revenue agents, and engineers. We also reviewed case files pertaining to first purchaser and operator examinations being conducted within the districts. This work was performed in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

1/In an earlier report ("Department of Energy Needs to Resolve Billions in Alleged Oil Pricing Violations," EMD-81-45, Mar. 31, 1981), GAO pointed out that numerous issues in the DOE price control regulations were still in litigation, that these issues could have a potential impact on windfall profit tax liability, and that the Commissioner of Internal Revenue should study these issues in drafting regulations for the windfall profit tax program. In response to that report, the Commissioner of Internal Revenue informed key congressional committees that IRS had anticipated these potential problems and had set up a regulations project to study the need for changes in the application of DOE regulations.

THE COST OF LIVING COUNCIL AND DOE DEFINED PROPERTY WITH REFERENCE TO CALENDAR YEAR 1972

Although petroleum prices were controlled as early as 1971 under President Nixon's general wage-price freeze, it was not until 1973 that a two-tier pricing system went into effect for domestic oil production. At that time, the Cost of Living Council framed the property concept so that "old oil" ceiling prices could not be avoided by transferring or subdividing land tracts. That is, property was defined as "the right to produce domestic crude oil, which arises from a lease or from a fee interest" as such right existed in 1972--the year before tiered price controls began. A fee interest in certain acreage refers to complete ownership, i.e., to all the land including the subsurface and any minerals. Typically, however, the fee landowner does not directly explore for and produce crude oil but rather leases the acreage to an individual or company experienced in such relatively risky and expensive ventures.

Because property is defined with respect to a specific base year--1972--subsequent transfers, segregations, or aggregations of land generally do not create new properties. Further, the property concept, which arises from the right to produce, is not flexible and does not change with the substitution of one lessee for another. For example, a 1,000-acre tract of land, owned or leased by one person, which produced oil in 1972, may have been subdivided into two 500-acre parcels and sold or leased to new parties after 1972. Those transfers have no effect on the definition of the property. There is still only one property--the 1,000-acre land tract--because that tract equates to the right to produce oil as it existed in 1972. The new parties merely obtain portions of the basic or integral right to produce. Post-1972 subdivisions generally do not create new properties, although DOE rulings do identify some exceptions to this basic rule.

DOE, 1/ which assumed responsibility for administering petroleum price controls in 1973, adopted the property concept thinking it would provide industry a common and easily understood basis for classifying production. The oil industry, however, experienced various problems in seeking to apply the concept to its normal operations. For example, normal industry practice often called for aggregation of leases to maximize oil production and minimize costs in a particular area. Under DOE

1/DOE, as used throughout this report, includes the agency's predecessor organizations, i.e., the Federal Energy Office and the Federal Energy Administration.

regulations, however, questions arose as to whether new properties were created from the aggregated leases. After several industry requests for clarification on this and other aspects of the property concept, DOE issued three rulings on property--one in 1975 and two in 1977. In these rulings, DOE attempted not only to clarify the property concept but also to identify certain circumstances whereby rights to produce could be aggregated or segregated to create separate properties. In so doing, DOE made the property concept somewhat less strict in an effort to provide production incentives.

Still, the property concept remains problematic. Extensive ongoing litigation involves differing views as to the meaning and validity of various aspects of the concept. Much of this litigation resulted from administrative enforcement proceedings initiated in May 1979 by DOE against seven major oil companies. DOE's legal action, which is based largely on property-related issues, alleges millions of dollars of pricing violations by the companies.

Since the adjudication of energy issues is time consuming and complex, these property issues may not be resolved by the courts for several years. Ironically, uncertainties over the property concept, the cornerstone of the crude oil price control program, have outlived that temporary regulatory program and have become a focus of controversy in another temporary program--the windfall profit tax.

THE BASIC DETERMINANT OF THE WINDFALL PROFIT TAX RATE IS DOE'S PROPERTY CONCEPT

For windfall profit tax purposes, the definition of property is singularly important because the concept controls the category or tier of crude oil which, in turn, establishes the applicable tax rate from a range of 30 percent to 70 percent. Appendix I contains a synopsis of the various tiers and tax rates.

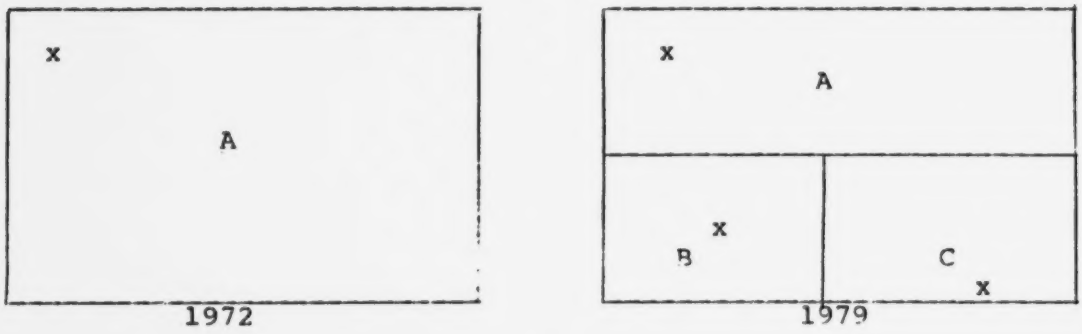
Given the variance among windfall profit tax rates, it is axiomatic that owners of interests in oil production will prefer the lower tax rates associated with tier 2 or tier 3 oil over tier 1, which carries the highest rate. Moreover, this preference or incentive will increase under provisions of the recently enacted Economic Recovery Tax Act of 1981. As appendix II shows, independent producers' tier 2 stripper oil will be exempted from the windfall profit tax beginning in 1983. The tax rate on newly discovered and other tier 3 oil will be phased down to 15 percent by 1986. Tier 1 old oil will continue to carry high tax rates.

Given the current and prospective tax rate differentials, compliance issues are inevitable; the incentive for classifying oil as newly discovered or stripper as opposed to old is very

great. Figure 1 illustrates that IRS examiners cannot properly check for misclassified oil unless they understand and make property determinations.

Figure 1

Examples of How Improper Property Determinations Can Lead to Windfall Profit Tax Rate Errors (note a)



a/As of 1972, operator A was the lessee of a certain tract of land. Operator A had one producing oil well ("x") located in the northwest portion of the leased tract. This well has produced oil continuously since 1972. In 1979, operator A assigned to B the right to produce the southwest quarter and to C the southeast quarter. Subsequently, operators B and C each brought in a producing well ("x"). Generally, since property is defined as the right to produce as of 1972, there is still only one property. The 1979 assignments did not create separate properties.

Operators B and C might be classifying their production as newly discovered oil, which has a windfall profit tax rate of 30 percent. But, by definition, this oil cannot be newly discovered. For tax purposes, newly discovered oil is defined as oil produced from a property which had no production in 1978. In this example, the property did have production, i.e., from the well in the northwest portion of the property. Thus, oil from all three wells generally should be taxed as old oil, which has a windfall profit tax rate of 70 percent for integrated oil companies and 50 percent for independent producers.

Similarly, Operators A, B, and/or C might be certifying their production as stripper oil. But, again by definition, this oil generally cannot be classified as stripper unless the average daily production per well on the property did not exceed 10 barrels per day. The production from all three wells must be averaged in order to make that determination.

DOE's experience in enforcing price controls is illustrative of the fact that oil misclassification does occur. The agency's audit reports for the period September 1973 to December 1979 allege that 26 major companies overcharged consumers a total of $1.05 billion. Of this amount, $711 million, or 68 percent, was attributable to misclassifications arising from property-related issues, such as

--improper aggregation of single properties for accounting purposes;

--inappropriate treatment of reservoirs not recognized by State regulatory agencies;

--erroneous treatment of drilling units or conservation units as separate properties; and

--improper segregation of single properties based on individual wells, working interest ownership, division orders, royalty ownership, or tank batteries.

These issues also affect the windfall profit tax program because property has the same meaning for tax classification purposes as it did under energy price control regulations. Given the magnitude of DOE's alleged findings, the importance of property in determining tax rates, and the billions of dollars involved in the windfall profit tax program, it is imperative that IRS examiners have a firm understanding of the property concept. Otherwise, tier misclassifications will go unchallenged during windfall profit tax examinations. In terms of revenue effect, tier misclassification is potentially the most significant compliance issue confronting IRS in the windfall profit tax program.

TREASURY AND IRS NEED TO PROVIDE GUIDANCE ON PROPERTY ISSUES

Although the property concept is fundamentally important to administration of the windfall profit tax, it has been afforded little attention by Treasury and IRS. We attribute this to the complexity of the tax rate structure and the fact that Treasury and IRS have been faced with an enormous task in seeking to develop and implement a compliance program. Regardless, property issues now need to be addressed on an expedited basis.

Basically, IRS' examination of whether an operator--the individual who actually manages the oil production process--has correctly reported the windfall profit tax tier of crude oil produced should be a two-step process. As presented earlier in figure 1, the first step is to make a property determination. This involves identifying the right to produce as it existed in

1972. Once a property determination has been made, the production from that property must be classified as either tier 1, tier 2, or tier 3 oil. For example, if average daily production of crude oil per well on a property did not exceed 10 barrels per day during any preceding consecutive 12-month period, the oil is classified as tier 2 stripper oil. If the wells on a particular property had no production in calendar year 1978, the oil is classified as tier 3 newly discovered oil.

We found that IRS' examination process was either missing or mistreating the overridingly important first step. District office personnel did not understand the property concept and its relation to tax tier. In particular, IRS examiners did not know that the term property, as incorporated from DOE regulations, refers to the right to produce oil as that right existed in 1972. In some instances, examiners were simply accepting existing leases as properties regardless of the lease dates. In other instances, examiners did look for original leases but without regard to any reference year.

This situation was clearly reflected in the windfall profit tax case files we reviewed. For example, in one case, an examiner selected three leases for review. The operator had certified that oil produced from these leases qualified for tier 3 tax treatment. The examiner determined, through a review of State regulatory records, that the wells on each lease had no production in 1978 and therefore concluded that the operator had properly certified the oil as tier 3 or newly discovered. In this instance, however, a property determination was not made. Rather, the examiner verified the classification process without first determining the status of each lease with reference to calendar year 1972. Because IRS examiners' workpapers do not include copies of lease history documents, we were unable to make a property determination. The subject taxpayer may have correctly classified the oil as tier 3. Nonetheless, the point remains that the IRS agent's examination approach was basically deficient.

On the basis of the results of our district office visits in IRS' Southwest region, we reevaluated the Service's windfall profit tax training program in terms of sufficiency of treatment of the property concept. We also attended a DOE training course on property. DOE's training course on the fundamental property concept was much more comprehensive than that given by IRS. In our view, IRS' training was inadequate because it did not (1) emphasize the importance of the property concept, (2) identify a base year for making property determinations, or (3) specify how examiners should make property determinations.

The seriousness of our finding prompted us to discuss the property issue with representatives from IRS' Southwest regional office. Although our concerns were based on a limited scope

inquiry, we wanted to bring them to IRS' attention as early as possible. That discussion led to a joint IRS/General Accounting Office evaluation of the two "most-developed" examination cases involving property issues in IRS' Dallas district office. Together, we found that the examiners had verified oil tier classifications without determining the status of each lease with reference to the base year--1972.

Shortly thereafter, Southwest region representatives informed us that they had (1) suspended closure action on certain windfall profit tax operator audits pending issuance of revised guidance, (2) arranged for discussions with DOE representatives on the property issue, (3) started to reevaluate windfall profit tax training materials and audit guidelines, and (4) informed IRS' national office of the need for resolution of property-related issues. Subsequently, IRS brought the property issue to the attention of the Treasury Department. Thus, to the extent possible, the Southwest region has initiated corrective action. However, the property issue is not limited to one region but has program-wide significance. Guidance on the basic definition of property and the appropriate examination approach needs to be quickly disseminated nationwide to assure establishment of an effective IRS compliance program. And, by issuing better guidance, Treasury and IRS can facilitate taxpayer compliance with the law. This is especially important because the oil industry not only has raised questions about DOE rulings on the property concept but also has raised questions about how that concept applies to the windfall profit tax.

ADDITIONAL PROPERTY ISSUES HAVE BEEN RAISED

In May 1981, Treasury and IRS asked for public comments on the question of what changes ought to be made to DOE regulations in order to facilitate compliance with the Windfall Profit Tax Act. In responding to that request, the oil industry raised two major issues with respect to the property concept:

--First, would a provision of the act, which is primarily aimed at preventing property-related tax abuses during and after phased decontrol, affect the base year for making property determinations?

--Second, would the definition of property include land which was unleased and/or nonproducing as of 1972?

With respect to the first issue, we believe that the provision in the act which relates to transfers during and after phased decontrol does not change the applicable base year for making property determinations. Rather, this provision was designed to ensure that property determinations and oil classifications do not change simply because of decontrol. The second issue,

however, is more troublesome because neither DOE regulations nor the Windfall Profit Tax Act provide specific guidance. Regardless, guidance is needed on both issues.

Treasury and IRS need to respond to oil industry questions concerning the base year for making property determinations

To prevent compliance abuses, the definition of property must be fixed at a particular point in time. Otherwise, the windfall profit tax could be reduced substantially through creation of new properties. For example, if properties were not fixed as of a certain date, taxpayers could subdivide leases, drill new wells, and classify old oil as tier 3 newly discovered oil. For price control purposes, DOE regulations used 1972 as the basic reference year for properties. And, because those regulations were specifically incorporated by reference into the Windfall Profit Tax Act, 1972 should be generally used as the reference year for making property determinations for tax purposes.

However, certain oil industry representatives contend that the Windfall Profit Tax Act established 1978 as the base year for making property determinations for tax purposes. This argument overlooks, among other matters, applicable DOE regulations and rulings made in connection with those regulations.

The Windfall Profit Tax Act and its legislative history indicate that the definition of property for tax tier purposes has the same meaning as that term had under DOE regulations. The act defines the various oil tiers by reference to DOE regulations. For example, tier 2 oil is defined by section 4991(d) of the Internal Revenue Code in part as "any oil which is from a stripper well property within the meaning of the June 1979 energy regulations." And, as a general proposition, 1972 is the applicable base year for making property determinations under the June 1979 energy regulations. Moreover, both the House and Senate Committee reports have the identical comment on the basic definition of property. The committee reports essentially reiterate the statutory language and provide that property "has the same meaning as that term is given by the price control regulations."

In addition to the above references to the property concept and DOE regulations, section 4996(e) of the code states that:

> "In the case of a transfer after 1978 of any portion of a property, for purposes of this chapter (including the application of the June 1979 energy regulations for purposes of this chapter), after such transfer crude oil produced from any portion of such property shall

not constitute oil from a stripper well property, newly discovered oil, or heavy oil, if such oil would not be so classified if the property had not been transferred."

Certain oil industry representatives have raised a question whether this provision, entitled "Special rules for Post-1978 Transfers of Property," could change the base year for making property determinations from 1972 to 1978. Both the Senate and House reports on the act confirm that the overriding purpose of section 4996(e) was to prevent abuses arising from property transfers. By incorporating DOE regulations into provisions of the act other than section 4996(e), the Congress effectively precluded the use of property transfers as a means for reducing the windfall profit tax, at least for the time period during which those regulations governed oil pricing. Then, through section 4996(e), the Congress specified that property transfers could not be so used during or after phased decontrol, and again made reference to the DOE regulations. Post-1978 transfers are the relevant focus of section 4996(e) because phased decontrol began after 1978 and, concurrent with phased decontrol, DOE regulations governing price controls began to expire. Thus, section 4996(e) recognizes that DOE restricted property transfers for pricing purposes and that such restrictions would be continued for tax purposes with the advent of phased decontrol in June 1979.

To apply section 4996(e) to property transfers that occurred during the decontrol period and thereafter, IRS examiners would need to first determine the property's status as of 1978. To make this determination, the examiner would consult DOE regulations, which, as a general proposition, would require a further reference to the property's status as of 1972. Through the operation of section 4996(e), such classification would remain with the property during and after decontrol.

It should be recognized that had the Congress taken a different approach and established 1978 as the base year without regard to DOE regulations, all pre-decontrol transfers, segregations, and aggregations of land occurring during 1972-78 would have created new properties for windfall profit tax purposes. As a result, the same land tract could be part of two properties having different overall boundaries--one for pricing and another for tax purposes--and companies who committed property-related violations under DOE regulations could benefit from lower windfall profit tax rates.

Although we think the act and applicable implementing regulations are reasonably clear on the point that 1972 is the general reference year for making property determinations, there are a number of outstanding questions, discussed below, that relate to the treatment of certain land tracts which were not leased and/or which did not produce oil in 1972.

Treasury and IRS need to resolve uncertainties as to the scope of the property concept

Although 1972 generally is the reference year for making property determinations, oil industry representatives have raised a question about the scope of the property concept. Specifically, some industry representatives argue that the concept was never intended to encompass land tracts which were not leased and/or which did not produce oil in 1972. Neither the Windfall Profit Tax Act nor DOE regulations provide definitive guidance on this issue. Therefore, Treasury and IRS need to resolve the matter.

Basically, these oil industry representatives contend that the property concept was not intended to apply to land tracts which were in no way associated with anticipated or actual oil production in 1972. For example, given a 5,000-acre farm which had neither produced oil nor been leased to an oil operator in 1972, the representatives would contend that no property had been defined for DOE purposes. Instead, oil properties would not be created until the farm owner either executes an oil lease or independently initiates oil production. Other industry representatives would go a step further. They would contend that a property would not be created in this example unless and until oil is found and produced, regardless of whether the acreage was leased by an oil firm or developed by the landowner. These views of the scope of the property concept thus would permit certain post-1972 transfers, segregations, and aggregations of land.

Concerning revenue effects, these views of the property concept would result in a net reduction in windfall profit tax revenues. This is because as acreage is subdivided into smaller and smaller tracts, the probability is increased that production from any given tract will qualify as stripper oil or newly discovered oil.

These views would also result in a more complex examination process. This is because IRS examiners would not only have to determine the status of a land tract in 1972, they would also have to examine all subsequent land transactions to determine when an "oil property" was created. This, of course, could be a time-consuming task in many instances. The difficulties associated with an examination process of this type are illustrated in figure 2.

Figure 2

Examples of How a Less Strict Interpretation of the Property Concept Would Increase the Complexity of IRS Examinations (note a)

a/In 1972, there was no oil production on an unleased section (640 acres) of land; the right to produce the mineral interests was held by A. In 1976, A leased the southwest quarter to operator B and the southeast quarter to operator C. During that same year, operator C drilled and brought in a producing oil well ("x").

Assuming no further segregations or drilling, how many properties currently exist? Generally, under a strict interpretation of DOE's property concept, there is only one property--the 640 acres--because the right to produce as of 1972 encompasses this acreage. The answer would be quite different, however, if unleased and/or non-producing mineral interests could be segregated and treated as separate properties.

If the execution or existence of a lease is the determining factor in establishing a property, then, as of 1976, B's tract and C's tract are separate properties. By this interpretation, the northern half of the section, still unleased, would not be a property and could be further segregated by future leases to create additional properties.

If actual oil production is the factor which establishes a property, only C's tract is a property as of 1976. As above, A can still subdivide the northern half of the 640 acres. Similarly, even though B has a lease, that tract has no oil production; thus, the acreage can be further subdivided to establish more properties.

Thus, to make a property determination, IRS examiners would have to trace all transactions related to this 640-acre land tract beginning with 1972 as the base year and ending with the tax year under examination.

Treasury and IRS thus need to address these industry contentions. The Secretary of the Treasury is authorized by the Windfall Profit Tax Act to modify DOE regulations as necessary or appropriate for tax purposes. The Secretary, in consultation with IRS, needs to exercise that authority to clarify the property concept.

CONCLUSIONS

Being the basic determinant of tax tier, the property concept is the cornerstone of the windfall profit tax. As such, the definition and scope of the concept should be well established during the early stages of the windfall profit tax program. This is especially important because the tax is of temporary duration and will be phased out over a 33-month period beginning no later than January 1991.

There is, however, considerable uncertainty over various aspects of the property concept within both IRS and the oil industry. Initial IRS examinations reflected inconsistent and inaccurate treatment of the property concept; thus, the closure of certain cases has been suspended pending development of more definitive guidance. Similarly, some oil companies have raised questions about the reference year for making property determinations and about the scope of the property concept. Uncertainty over the meaning of a cornerstone term promotes neither voluntary compliance nor effective IRS examinations. Thus, Treasury and IRS need to quickly resolve uncertainties over the property concept.

RECOMMENDATIONS

We recommmend that the Secretary of the Treasury give a high priority to clarifying the property concept for windfall profit tax purposes. Specifically, we recommend that the Secretary clarify the definition and scope of property for tax tier purposes, including the correct reference year for making property determinations and the proper treatment of land tracts which were unleased and/or did not produce oil in 1972.

As part of this process, we also recommend that the Secretary require the Commissioner of Internal Revenue to (1) revise windfall profit tax training materials and (2) provide IRS examiners with more specific guidance on how to make property determinations.

AGENCY COMMENTS AND OUR EVALUATION

By letter dated April 29, 1982, the Assistant Secretary for Tax Policy, Department of the Treasury, informed us that Treasury and IRS were studying the property issue. The Assistant Secretary

further stated that a notice of proposed rulemaking concerning the property concept would be issued. Public comments on the proposal will be solicited before a final decision is made by the Treasury Department. Appendix III contains a copy of the Treasury Department's comments.

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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

Copies of this report are also being sent today to the Commissioner of Internal Revenue; the Director, Office of Management and Budget; and other interested parties.

We appreciate the assistance provided us by Treasury and IRS staff. We are continuing our survey of your efforts with respect to the windfall profit tax and will bring additional issues to your attention as appropriate.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

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APPENDIX I

CRUDE OIL WINDFALL PROFIT TAX (WPT) RATES BY OIL TIERS AND PRODUCER STATUS

WPT oil tiers and exempt oil	Producer Status: Integrated oil company (note c)	Independent producer (note d)	Royalty owner (note e)	Exempt producers: (note f) Qualified governmental interests; Qualified charitable interests; Indian oil; Front-end tertiary oil
	Windfall Profit Tax Rates			
Tier 1: (note a) Old oil	70%	50%	70%	
Tier 2: Stripper oil; National petroleum reserve oil	60%	30%	60%	
Tier 3: Newly discovered oil; Heavy oil; Incremental tertiary oil	30%	30%	30%	
Exempt oil: (note b) Exempt Alaskan oil	-	-	-	

Notes:

a/The WPT Act defines tier 1 oil by exclusion, i.e., such oil means "any taxable crude oil other than tier 2 oil and tier 3 oil." Generally, tier 1 oil may be referred to as old oil. In tier 2, the main category is stripper oil, which is defined as crude oil from a property whose average daily production per well does not exceed 10 barrels per day. In tier 3, newly discovered oil is perhaps the most important category. This is oil from a property which had no production in one specific year, 1978.

b/Certain Alaskan oil is exempt from the WPT. This exemption includes oil produced from a reservoir that has been commercially exploited by a well located north of the Arctic Circle, other than oil from the Sadlerochit reservoir at Prudhoe Bay. Also included is oil produced from wells located south of the Arctic Circle but north of the divide of the Alaska-Aleutian mountain range if the well is at least 75 miles from the nearest point on the Trans-Alaskan Pipeline System. (See also note f below).

c/For WPT purposes, an integrated oil company is a retailer or a refiner. A retailer is any taxpayer who directly (or through related persons) sells oil or natural gas (or any derived product) through retail outlets, provided that such sales exceed $1.25 million in a taxable quarter. A refiner is any taxpayer engaged in the refining of crude oil directly or indirectly and has total refinery runs exceeding 50,000 barrels on any day in the taxable quarter.

d/To qualify as an independent producer, the taxpayer must not be an oil or gas retailer or an oil refiner during the taxable period, i.e., during the quarter (see note c). The reduced tax rate for an independent producer applies only to the first 1,000 barrels of oil per day of combined production of tiers 1 and 2 oil. Since independent producers account for a large portion of domestic exploratory drilling, Congress granted these producers special rates to encourage drilling activities.

e/Royalty owners include any owners of economic interests (in oil properties) that are defined as royalties for income tax purposes. This includes landowner royalties, overriding royalties, and net profits interests. Production arising from a royalty interest (or other nonoperating interests) is not eligible for the special reduced rates granted to independent producers. (Only production arising from working interests owned by independent producers qualifies for the reduced rates). Generally, royalty owners are subject to the same WPT rates as integrated oil companies. However, royalty owners get one benefit not available to integrated oil companies--the benefit of claiming percentage depletion on the full price of the oil. Integrated oil companies, by statutory definition, do not qualify for percentage depletion.

f/Production with respect to the economic interest in a property held by State and local governments is exempt if the net income from the property is dedicated to a public purpose.

Also exempt is production from properties owned on January 21, 1980, and at all times thereafter, by a qualified charitable educational or charitable medical facility.

The WPT Act also exempts oil production owned or received by Indian tribes, tribal organizations, and individual Indians over whom the United States exercises trust responsibilities from mineral interests held by or on behalf of Indian tribes or individual Indians on January 21, 1980.

Additionally, front-end oil is either exempt from the windfall profit tax or, for non-exempt front-end oil, the tax is refundable to the extent allowed expenses are not recouped. Front-end oil is oil which DOE deregulated in connection with a program to encourage enhanced oil recovery projects by providing "front-end" financing. That is, under the program, certain oil was released from price controls if the additional revenue resulting from decontrol was used to finance a tertiary recovery project. The front-end oil may be produced from properties wholly unrelated to the tertiary recovery project being financed. In this regard, the exemption allowed for certain front-end oil may be termed a producer exemption.

APPENDIX II

WINDFALL PROFIT TAX REDUCTIONS IN THE ECONOMIC RECOVERY TAX ACT OF 1981

Oil Tier/ Classification	New WPT Provisions Tax rate	Effective date(s)	Producers affected
Tier 1 (Old oil)	No changes		
Tier 2 (Stripper oil)	Exempt	1983 and later	Independents only
Tier 3 (Newly discovered, heavy, and incremental tertiary oil)	27.5%	1982	All
	25.0%	1983	All
	22.5%	1984	All
	20.0%	1985	All
	15.0%	1986 and later	All

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

29 APR 1982

Dear Mr. Anderson:

This is in reply to your memorandum of March 15, 1982, which requested that the Department of Treasury comment on the GAO draft report "Uncertainties about the Definition and Scope of the Property Concept May Reduce Windfall Profit Tax Revenues" (GGD-82-48).

The draft report recognizes that the DOE regulations and rulings have not been sufficiently precise with respect to the definition of the term "property" and, more specifically, the extent to which property interest determinations are controlled by the January 1, 1972 reference date. As a result of this lack of clarity, arguments can be made for having property boundaries determined by reference to the boundaries of the right to produce crude oil which were in existence as of: (1) 1972 (the year generally used for property determinations under DOE regulations); or (2) 1972 or, in the absence of crude oil production pursuant to a right existing in 1972, the time of first production; or (3) 1972 or, if the right existing in 1972 was not evidenced by an oil and gas lease or other instrument specifically transferring the mineral rights, the time of first production or the first execution of such lease or instrument, whichever is earlier.

The Internal Revenue Service is cognizant of the need for public guidance in this regard. It has for some time been working on a regulations project directed toward resolving the property issue. While we share your concern that this question be addressed promptly we note that the uncertainties that exist concerning the property concept, and the very considerable impact the regulations will have, compel us to solicit public comments by way of a notice of proposed rulemaking. Only after public comments have been

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received and considered will we be able to issue final rules. We will, of course, make every effort to expedite the regulations project. We appreciate receiving your analysis of the DOE regulations and rulings. It will be fully considered in our rule making process.

Sincerely,

John E. Chapoton
Assistant Secretary
(Tax Policy)

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

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